



September 7, 1965

Letter 299

**THE MARKET:** Question: Russell, what can we really say about this market?

Answer: We can say that the Industrial Average is rapidly approaching a 16-year bull market peak, a peak which was recorded in May, 1965 at 939.62. We can say that this market is going up almost entirely on the remaining momentum of this 16-year surge. We can say that the market is in an extremely dangerous position with the technical situation (huge short position, continued odd-lot selling, upward zig-zags in the Averages) providing the strength and the long-term fundamental situation (a current 55-month record economic expansion, historically low stock yields, bearish bank credit statistics according to the latest Bolton-Tremblay Bank Credit Analyst) providing the potential trouble. Finally, we can say that as Industrials try for the May high of 939.62 we are almost certain to witness some history-making drama (indeed the advance is now assuming some of the characteristics of a "blow-off"). One reason for the expected drama is contained in Chart 2. You do not have to be a stock market technician to see the smoldering "dynamite" in this chart formation.

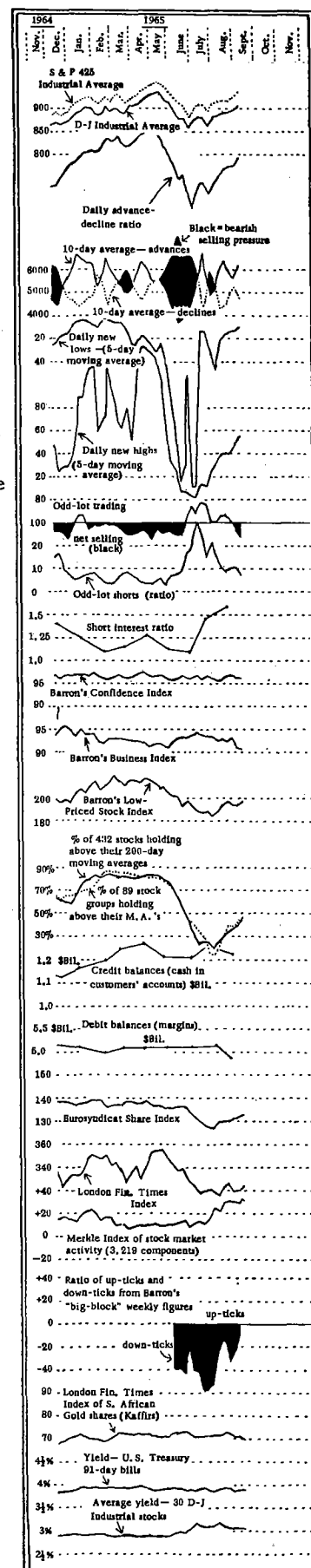
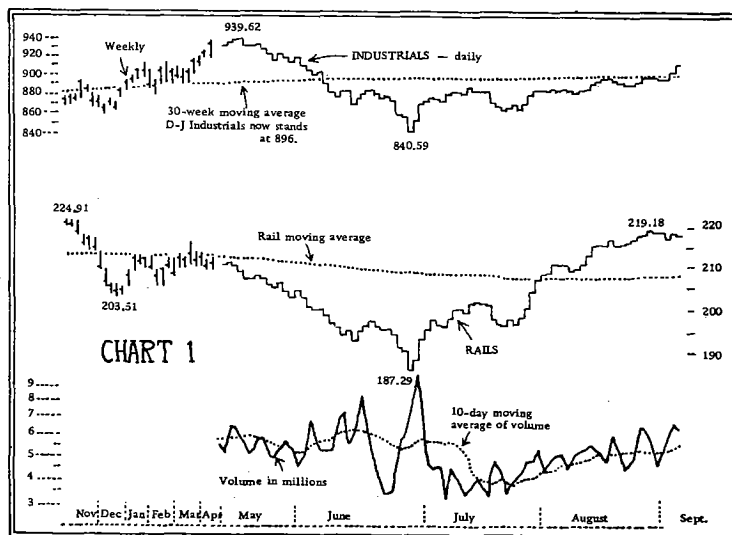
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The decline from the bull market peaks (939.62 and 224.91) to the June, 1965 lows erased 99 points from the Industrial Average and 37 points from the Rail Average. The subsequent rally from the June low to last week's high served to recover a surprising 87% of the Rail losses, 66% of the Industrial losses. A study of all past secondary (upward) corrections suggests that they usually recoup a third to two-thirds of the ground lost on the preceding downward leg. In time they generally last from three weeks to three months. In point of time the current correction is normal. In extent, Rails have surpassed average expectations while Industrials are close to a two-thirds correction.

After watching markets and keeping daily statistics for many years, this writer has developed what any student in his own field sooner or later develops, an instinct or a "feel" for the unusual or the out-of-place. And this advance is not without its own unusual phenomenon. I noticed it a few weeks ago and brought it to the attention of subscribers in Letter 297; the extraordinary thing about this advance is the performance of the advance-decline ratio (known as market breadth). Although still far from its 1965 high (see Composite Chart), the A-D ratio has put together a string of "plus" days which, to my knowledge, is unprecedented in the history of the stock market. In fact, the breadth performance since July 28 is so unusual that I believe it is worth going into this factor in greater detail. The following is a series of observations which I would like all subscribers to study most carefully.

The advance-decline ratio (like the Averages) seems to be subject to a law of physics — the law of action and reaction. Over any reasonable length of time the number of days of advance tends to equal the number of days of decline — regardless of whether the market is in a bull or bear phase.

For instance, in the crushing year 1962 there were 127 days in which the A-D ratio (breadth) declined and 116 days in which breadth advanced, a difference of only 11 days. In the profitable year 1963 there were 128 days of advancing breadth and 117 days of decline, a difference again of only 11 days. Total for the two years: 244 days of advance and 244 days of decline. This law of action and reaction is something that subscribers should always remember.



Page 2      Applied to the present, in the 27 trading days since July 28, the A-D ratio has risen on 24 days, and I believe this constitutes an all-time record. But since we have now had 24 out of 27 days of advancing breadth (breadth has been up 89% of the time) we can expect the inevitable "evening out" process to occur in the period ahead. It should be remembered that the greater the string of advancing breadth days since July 28, (1) the more "strained" the market will be technically, (2) the longer and probably the more severe will be the correction.

As this is written the Industrial Average is pushing towards what could easily turn out to be a "double top" in the 940 area or a "broadening top" (see discussion in later part of this Letter). If Industrials continue their rally with breadth also continuing its string of rising days, we will have a picture of extraordinary strain. Another few weeks of the kind of action we have seen since July 28 and I warn subscribers that they can expect anything. The market can be "a law unto itself" for a while, but sooner or later "normality" takes over. Normal action in any period ahead would imply trouble.

Remembering that the tendency of breadth over any period of a year or more is to produce an equal number of advancing and declining days, it is worth noting that so far in 1965 we have produced 105 days of advancing breadth and only 61 of declining breadth. With 81 trading days left to complete this year, if breadth were to even out we might expect only 21 more days of advancing breadth and 63 more days of declining breadth. In other words, if breadth were to tend to even out we could get three down-days in breadth for every up-day from now to the end of the year.

**INDUSTRIALS:** Letters 292 and 293 discussed in detail the huge potential "broadening structure" in the Industrial Average. In Letter 293 I noted: "This market has shattered every precedent, both on the uncorrected 1962-65 advance and on the straight-line 1965 decline. I must admit that the following thoughts have been going through my mind this week. Could the market now commit the 'crowning irony' by surging up towards the highs again — thereby scaring the shorts into mass covering as well as re-igniting the hopes of the bulls? Then, upon approaching or even bettering the May Industrial high, might not the whole structure then come crashing down on greater volume and with more violence than anything yet seen?"

I have brought Chart 2 up to date, and it is well to note the formation of the four reversal points on the Industrial Average with the fifth potential reversal point somewhere ahead. The dangerous looking (highly-erratic) structure which has been in the process of forming since late-1964 will immediately bring to the mind of older subscribers the possibility of a broadening top. The broadening top is a five-point reversal pattern with each low below the preceding low and each high above the preceding high. Such patterns are extremely rare, and the only completed broadening top ever to appear in the Averages occurred in mid-1957 prior to the 100 point drop.

In order for the current structure to be completed (as a true broadening top), Industrials would have to push up above point 5 (above 939.62) then turn down and smash through the lower trendline (below point 4). Such a movement is certainly possible over the period ahead, but I have warned subscribers that the fifth leg of a broadening top is a most difficult and dangerous movement to "play." This "fifth leg" could well be the leg which the market is on at present.

In order to document the difficulty (and danger) of speculating in this type of market, I have taken the liberty of quoting a very interesting paragraph from the August 27 report by the astute market analyst, Mr. Anthony Gaubis of New York (it should be remembered that Gaubis did not write the following with any idea of a broadening top or head-and-shoulder top in mind): "Actually, the stock market has made very little progress on balance since the first of the year, with many of the better-grade issues still being

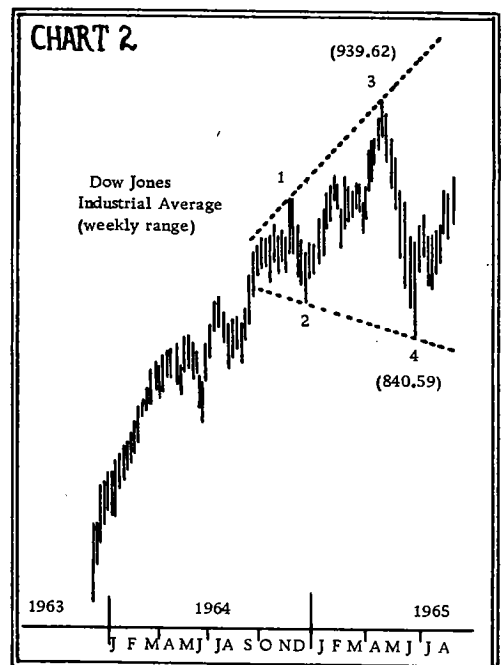
**SUNDRY COMMENTS:** The general impression being created in Washington is that this is the greatest "rubber stamp" Congress in history. Huge spending bills, requests for war expenses, vehicles of every sort have been sailing through the houses so fast that observers wonder whether our men in Washington have lost whatever power they might have had to think, argue or dissent. Newsweek (August 23) notes: "...floor debate in the 89th has often seemed a parody of Congressional deliberation. The voting-rights bill... was discussed in the House in just four days. Medicare in the Senate took no longer. The House repealed Section 148 of the Taft-Hartley Act so fast that one Democrat had to borrow time from Republicans to introduce amendments. Even... Dirksen, the Senate Majority Leader, could cook up no serious opposition to the urban-affairs bill, which consolidates 115 government programs in one Cabinet post. 'If we're ever going to put an end to this gargantuan growth of government, it will be done at this end of Pennsylvania Avenue, not the other,' he thrummed."

But my friend Eliot Janeway (who thrives on writing inside stories one month to six months before they become general knowledge) sees other events brewing. Indeed, Janeway views the sub-surface Washington scene as the single biggest threat to domestic tranquility and therefore as one of the biggest (as yet unrecognized) threats to the stock market. How is this for a "contrary" observation and opinion (from the August 17 Janeway Service):

**"LBJ vs Congress.** This conflict is very much further along than opinion suspects — as yet. General lack of awareness about the steady drift towards a rift in this all-important relationship has created public vulnerability to psychological shock, as well as to real damage. In our judgment, the break-down in White House communications with Congress, and the growth of Congressional antagonism towards Johnson personally and toward the White House operation in general, is now the most serious single minus to be counted against the equilibrium of our political economy. We regard the collision course that the White House is on with Congress as a greater danger to equilibrium than anything that might happen in Vietnam (or, certainly, than anything deGaulle might do).

"Congress' continued willingness (in the self-interest of its Members), to pass pending legislation, and Johnson's angle in pointing with pride to the legislative record, are political window-dressing which covers the step-up underground in-fighting and maneuvering for position.

"To take just one of many explosive examples: LBJ had been leaning heavily on Senate Majority Whip, Russell Long, to wage psychological warfare for him against Senators who are already hostile or turning independent; and, accordingly, he was flabbergasted when Long, of all current Presidential pets, 'went public' with a slashing attack featuring a few of the Congressional grievances against the Administration."



below levels reached during the last half of 1964. As of Thursday's close, the net gain in the Dow Industrials since the end of 1964 has been less than 3%. Looking behind the Averages, we find that advances in 3 of the 30 issues which make up the Dow-Jones Industrial Stock Average, more than accounted for the entire net gain, which means that the other 27 stocks, as a group, currently stand at slightly below where they were on December 31st. Furthermore, 21 of the 30 Dow Industrials closed last night below levels touched during 1964, with 15 of these 21 issues being between 10% and 27% below their 1964 highs. This record would seem to emphasize the truth of the statement that the chances of making money in individual stocks, or in any composite group of equities, have actually been below the fifty-fifty level for quite sometime, in contrast with the situation which prevailed during the last half of 1962 and throughout 1963. (August 27). "

The Composite Chart (Page 1) shows the two leading Industrial Averages continuing to head higher and "in gear" with the A-D ratio. From a Dow Theory standpoint, the Rail Average should now be watched with special reference to the last high (219.18) recorded on August 27 (see Chart 1). A bettering of 219.18 would put Industrials in position to approach the old May high, while a persistent refusal by Rails to better 219.18 would constitute the first seed of trouble.

The 10-day average of advances has again flared above the declines, indicating renewed buying power and diminishing selling pressure. Daily new lows have contracted to the lowest level since January, but daily new highs are still far below the 120-130 level of early 1965. Odd-lotters (who normally tend to buy less or to step up selling during an advance) are acting normally. Increased odd-lot buying during this advance would indicate technical weakness, but this has not yet occurred. The short interest ratio at 1.63 (together with the record 7.2 million short sales) are being used as the main argument for bullishness by bullish technicians. While it is generally held that the short interest will be under 4 million shares before this market turns down again, I do not agree, and feel increasingly certain that too many people are now using the short position for the bull argument. I feel this market will turn again with its large short position still intact. Barron's Confidence Index was unchanged at 96.2 this week, while Barron's Business Index (an adjusted index of heavy industry) dropped (at 90.6) to its lowest level in over a year. The percentage of stocks holding above their moving averages rose to 46% this week, still 4% under the critical 50% level. The Eurosyndicat Index has crept up to 132.8 and the London average has also pushed above the 320 level, the latter indicating renewed faith in the pound's ability to weather the next few months. The ratio of big block up-ticks to down-ticks was minus for the week ending August 30. The S. African gold index (which is heavily weighted with high cost mines) dropped to 68.9. Most of the leading individual gold shares recommended here, however, are still far above their January prices. The spread between Treasury bill yields and the average yield on the Dow Industrial yields is almost 1%, widest spread in four months.

Conclusion: Market is nearing an overbought condition for the intermediate term. The long-term situation continues to dictate that investors move towards liquidity.

It is one of the ironic facts of modern economic life that while leaders of the U. S. and Britain have been denouncing gold and scorning even the need for gold, Russia and China have embarked on giant state sponsored campaigns to accumulate as much of the yellow metal as possible. It is estimated that Russia produces about \$250 billion of gold per year. In 1963 the Russian wheat crop failed, and that year Russia was forced to purchase 12 million tons of wheat from the West. This meant that Russia had to sell an additional \$500 million of gold, above and beyond her "normal" annual gold sales of \$200 million. The 1963 gold sales are believed to have taken Russian gold reserves down to \$1 billion. But since the Soviets have sold no gold since 1963, it is probable that their reserves are now back at the \$1½ billion level.

It would be a serious mistake to underestimate the Russian preoccupation with gold. Interestingly enough, the drop in Soviet gold reserves in 1963 due to the agricultural failure is believed to be one of the chief reasons for Khrushchev's fall from power. Since 1963, concern about gold has loomed increasingly large in Soviet thinking. In early 1964 the Central Committee of the Communist Party inaugurated a nationwide drive to increase gold production. Huge gold dredges were ordered from West Germany, and in an unusual appeal, gold miners were called upon to join in "socialist competition" to exceed existing production plans and to reduce costs. More recently, the Soviets have gone to the extreme of asking all Russian and East German citizens to turn their gold jewelry in to the State. These extraordinary measures are probably due to the pressure to be exerted on Soviet gold reserves by the forthcoming purchases of wheat from Canada, purchases which again threaten to deplete Russian gold reserves.

Even more fascinating is the picture from China. As the accompanying newspaper clip from the August 22 New York Times implies, China is now building up her own gold supply. A few months ago the eyes of the world widened as it was announced that China had purchased about \$150 million of gold from the London gold pool — then flown this gold to Peking. This act was, of course, discouraging to Westerners who have hoped that China would be spending her gold for Western equipment rather than turning her London reserves of convertible currencies into gold and flying that gold home.

Few people realize that China is now running a \$200 million surplus in her balance of trade with Russia. Last year China completely wiped out her official state debt with the Soviets. "China's intentions are not known," runs the New York Times article. "A quantity of gold has already been shipped to China. And analysts say it would be in character for the Chinese Communists, who continually stress the need for self-reliance, to take advantage of their present favorable trade position to begin to make themselves financially strong and independent by stockpiling gold."

This writer wonders if the Chinese are not contemplating a move into the economic sphere in their battle with capitalism. The Vietnam war has been going on for months now and there has not been a sign of a Chinese entrance into the war (despite the fact that we have been dropping bombs literally within sight of the Chinese border). It would be foolhardy to underestimate the intelligence of the Chinese. They must see that a war against nuclear-armed America would be tantamount to self-destruction. But could the Chinese also see the economic Achilles heel, the fact that the U. S. is depleting its gold stocks at a rapid rate? Are the Chinese subtly switching their struggle with the West to the economic area — rather than the widely-feared battle arena? The 600 million Chinese (working for minuscule state-controlled wages) could in time represent a formidable factor in the export field, and such exports could rapidly produce a favorable Chinese balance of trade (incredibly, it is believed that the largest current Chinese dollar exports are opium and heroin).

Has China been building up its gold supply as a first step in a coming economic war with the West (a war which the Soviets have bungled due to inefficiencies, rising wages, poor production capabilities and accompanying agricultural disasters)? This writer is guessing that such an economic war is a very definite possibility. And I am betting that gold will play a vital part in the war.

### West Is Eying Buying by Chinese

Special to The New York Times  
HONG KONG—Economists here are trying to decide whether Communist China's sudden surge of buying on the London gold market this year is merely a temporary phenomenon or represents a long-term interest on the part of Peking in building up a small rival to Fort Knox.

Page 4      **STOCKS:** "Dear Mr. Russell: I am aware that you have recommended selling both short and long-term holdings on the current advance. But I am a man of 73 and I have owned some of my shares for years. For instance, I have GM at an average price of 7 and DuPont at an average price of 67. If I die my heirs will pay taxes on these shares taken at the price of these shares at my death, rather than original cost. Would it pay me to sell here? Sincerely, K. R., Short Hills, N. J. "

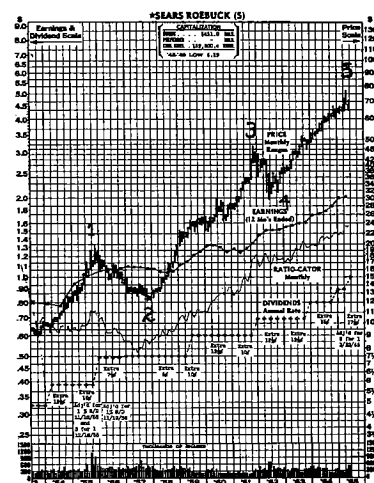
This is one of the most difficult questions in the book, and what you are really asking is "how low can the next bear market go?" No one has the perfect answer to that one. In similar instances, many intelligent individuals sell 1/3 or 1/2 of their holdings. This means that you can only be partly right if the advance extends itself considerably — but you can only be partly wrong if a major bear market materializes. At any rate, this is my (partly satisfactory) suggestion, based on your age and the extremely low average price of your holdings.

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In Letters 290 and 293 I suggested that subscribers might purchase one-year discounted put-options (a put is an option to sell at a fixed price but to buy at a later date at the later price). At the same time I discouraged short sales, and the value of that latter advice is now rather obvious. One-year puts were advocated (rather than shorts) because it was my opinion that a major bear market would start within a year, but a return by Industrials to the highs (a "double top") was also believed to be a distinct possibility. It should be remembered that a put is purchased at a specific price. Once you buy your put option, you have paid your money, and you cannot subsequently lose any more than the price of the put. If stock X runs up 30%, then collapses, the put holder stands to make money (on the collapse). But if stock X is shorted, and it then runs up 30% (prior to a collapse) the short seller will doubtless cover (as he should), thereby losing both his money and his sleep. My advice — if you're bearish on the big picture, buy puts rather than shorts (unless you are a professional trader).

Put options may be purchased through your broker (usually working through a New York put & call house). I urge you to buy only one-year puts, and to buy puts below the market. In other words, a one-year put on Sears may cost \$800 at today's market price for Sears at 67. But a discounted put on Sears (at say a price of 60) might cost \$400. The "at the market" put would make money if Sears dropped below 59. The discounted put would only make money if Sears dropped below 56. But the discounted put has the advantages of tying up less cash and possessing greater leverage in the event of a real collapse. And you should never buy a put unless you expect a collapse.

I have discussed in previous Letters the observation that 5 major legs often complete an important bull or bear market. This theory allowed us to buy Burroughs in the 22 to 24 area (Letter 258) prior to a 50% rise (BGH had completed a 5-leg bear market). In Letter 293 I showed charts of Georgia-Pacific and Celanese as examples of stocks which had probably completed major 5-leg bull market (3 legs up, 2 legs down) of their own. I am now including a monthly chart of Sears Roebuck as an example of another stock which is probably in the process of completing a long, 5-leg bull market. As such it is also a candidate for one-year discounted puts. Note that if Sears wiped out only its 5th leg, it would lose better than half its current market value. Other stocks in this same "5-leg completed bull market" category are Federated Dept. Stores, Armstrong Cork, General Motors, FMC Corp., General Foods, Macy, Gimbel.



According to Edwards and Magee ("Technical Analysis of Stock Trends") "The broadening top.. is an indication of a wildly gyrating market, a market without leadership or definite trend. The presumption is that heavy distribution is going on under cover of the rallies; and the breakout move is seldom a false one." In going through the Quote Digest weekly chart book (110 N. Lorraine, Wichita, Kansas) I was surprised to find at least a dozen stocks in broadening patterns. Six of these issues are shown below. These rare patterns bespeak the gyrating and distributing characteristics of the current market. Commenting further about broadening formations, Edwards and Magee state: "We have come to the conclusion that they are definitely bearish in purport — they, while further advance in price is not ruled out, the situation is nevertheless approaching a dangerous state."

Chart of Sears courtesy of Securities Research Corporation, 211 Congress Street, Boston, Massachusetts 02110.

